

AUDITOR'S REPORT OF THE AUDITOR-GENERAL TO THE FREE STATE LEGISLATURE AND THE COUNCIL ON METSIMAHOLO LOCAL MUNICIPALITY

REPORT ON THE CONSOLIDATED FINANCIAL STATEMENTS

Introduction

I was engaged to audit the accompanying consolidated financial statements of the Metsimaholo Local Municipality, which comprise the consolidated statement of financial position as at 30 June 2010, and the consolidated statement of financial performance, statement of changes in net assets and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information, as set out on pages ... to

Accounting officer's responsibility for the consolidated financial statements

The accounting officer is responsible for the preparation and fair presentation of these financial statements in accordance with South African Standards of Generally Recognised Accounting Practice (SA Standards of GRAP) and in the manner required by the Local Government: Municipal Finance Management Act of South Africa, 2003 (Act No. 56 of 2003) (MFMA). This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor-General's responsibility

As required by section 188 of the Constitution of South Africa, 1996 (Act No. 108 of 1996) and section 4 of the Public Audit Act of South Africa, 2004 (Act No. 25 of 2004) (PAA) and section 126(3) of the MFMA, my responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with the International Standards on Auditing and *General Notice 1570 of 2009* issued in *Government Gazette 32758 of 27 November 2009*. Because of the matters described in the Basis for disclaimer of opinion paragraphs I was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for disclaimer of opinion

Property, plant and equipment

As a result of the matters detailed below, I was unable to obtain adequate audit evidence as to the existence, rights, valuation and completeness of property, plant and equipment amounting to R308 904 375 (2009: R302 673 809), as presented in the statement of financial position for the current and previous financial years, and the related detailed disclosure in note 8 to the financial statements.

- The municipality does not have an updated, sufficiently detailed and accurate asset register in respect of its infrastructure, community, heritage and housing assets nor its land and buildings. The current register contains insufficient evidence to allow for the tracing of specific assets from the register to the physical asset, from the physical asset to the asset register, to confirm the values of these assets and to trace specific assets on the register identified from other sources. Assets sold during the current and previous financial years have not been removed from the respective asset registers as the entire proceeds were recorded in profit on sale of assets. The Municipality's records did not allow the performance of alternative audit procedures. Consequently, I was

unable to satisfy myself as to the existence, rights, completeness, and valuation of infrastructure, community, heritage and housing assets as well as land and buildings amounting to R285 483 436 (2009: R276 143 657).

- An unreconciled difference of R3 925 795 was identified between the reconstructed asset register for moveable assets and the balance presented in the statement of financial position and that disclosed in note 8 to the financial statements. Consequently, I was unable to obtain sufficient appropriate supporting documentation to confirm the existence, completeness and valuation of, and the rights relating to, the leasehold property and other assets amounting to R23 420 938 (2009: R26 530 152).
- I was unable to satisfy myself of the rights, existence, completeness and valuation of additions to property, plant and equipment amounting to R3 253 223 relating to network and computer equipment capitalised during the year under review. The amount capitalised is the payments already made in terms of the lease agreement and does not represent the value of the assets and services received by the municipality. Consequently, the assets received have not been recorded correctly, no liability in terms of the finance lease obligation has been recorded, the VAT claimable is misstated, finance costs are misstated and the classification of the liability as a contingent liability by the municipality in note 39 is incorrect.
- Included in the reconstructed asset register of the municipality are assets with a book value of R557 420, which could not be physically verified. This list has been presented to the council for authorisation to remove the assets from the register. Consequently, property, plant and equipment are overstated by R557 420.
- The municipality did not review the residual values and useful lives, or the impairment of assets for the current reporting date in accordance with SA Standards of GRAP, GRAP 17, *Property, plant and equipment*, and GRAP 26, *Impairment of cash-generating assets*. No adjustment was therefore made to the depreciable amount of assets resulting in the misstatement of depreciation and accumulated depreciation. In addition, this was not reviewed in financial years prior to 2009, resulting in assets being written down to a nominal value. I was unable to confirm or verify by alternative means the value of property, plant and equipment included in the financial statements.
- Infrastructure assets of R230 213 984 (2009:R223 482 187) as disclosed in note 8 to the financial statements have not been recognised in accordance with the component approach, as required by SA Standard of GRAP, GRAP 17: *Property, plant and equipment*. The municipality did not identify significant components to be depreciated separately and consequently the valuation of property, plant and equipment, the accumulated depreciation balance, as well as depreciation written off, could not be verified.

Revenue

As a result of the audit findings detailed below, I was unable to verify the occurrence, completeness, accuracy, classification and cut-off of revenue amounting to R458 216 582 (2009: R381 531 946) as presented in the statement of financial performance for the current and previous financial years.

- I was unable to verify the occurrence, accuracy, completeness, classification and cut-off of service charges amounting to R253 475 913 (2009: R201 519 341) as per note 19 to the financial statements due to the following:

- The SA Standard of GRAP, GRAP 9, *Revenue* requires that revenue shall be recognised when the outcome of a transaction involving the rendering of services can be estimated reliably. Differences between the actual meter readings and the meter readings as per the municipality's accounting system on which levies were charged for the year were identified. Service charges amounting to R12 559 423 did not occur and R2 638 907 were not accurately accounted for. Consequently, consumer debtors were overstated in the current financial year. Service charges and consumer debtors were overstated by R5 451 850 in the previous year.
- Service charges were not properly accounted for in the period between the last meter reading and year-end; consequently service charges were not complete, accurate and recorded in the correct accounting period. Service charges were understated by R12 936 158. Accumulated funds and consumer debtors are understated by R12 320 150 and R616 008, respectively.
- I was unable to verify the completeness and accuracy of service charges as 2 330 (2009: 5 679) properties in the municipal area were identified from which no service charges are being recovered. The entity's records did not permit the application of alternative audit procedures.
- The occurrence, classification, completeness and accuracy of service charges amounting to R32 570 000 could not be confirmed as sufficient appropriate audit evidence could not be obtained to substantiate the journal entry. Alternative procedures were considered, but could not be performed as the journal entry in the accounting records of the municipality should be supported by source documents which are internally generated documents that can only be prepared by the municipality itself.
- There was no system of control over other income on which I could rely for the purpose of my audit, and there were no satisfactory audit procedures that I could perform to obtain reasonable assurance that all other income was properly recorded in the correct accounting period and classified correctly. Consequently, I was unable to obtain sufficient appropriate audit evidence to satisfy myself as to the completeness, accuracy, cut-off and classification of other income as disclosed in note 20 to the financial statements amounting to R10 305 744 (2009: R14 014 276) as presented in the statement of financial performance.
- There was no contract management system in place for the identification and recognition of rental contracts and there were no satisfactory alternative audit procedures that I could perform to obtain reasonable assurance that all rental income was completely recorded and classified correctly. Consequently, I was unable to obtain sufficient appropriate audit evidence to satisfy myself as to the completeness and classification of rental income of R4 135 741, as stated on statement of financial performance.

Non-current provisions

The completeness of non-current provisions as disclosed in the statement of financial position amounting to R18 097 600 (2009: R16 803 798) could not be verified. This was as result of oversight by management. I was unable to quantify the liabilities as at the end of both years due to the complexity of the calculations involved.

- The municipality did not provide for the rehabilitation of landfill sites in the current and prior year, as required by section 28(1) of the National Environmental Management Act, 1998 (Act No. 107 of 1998) and in accordance with the SA Standard of GRAP, GRAP 19, *Provisions, contingent liabilities and contingent assets*.
- The South African Statement of Generally Accepted Accounting Practice, IAS 19, *Employee Benefits* states that the amount recognised as a liability for other long-term employee benefits shall be the net total of the present value of the defined benefit obligation at the end of the reporting period minus the fair value at the end of the reporting period of plan assets (if any) out of which the obligations are to be settled directly. Contrary to this requirement, the municipality did not provide for long-service awards at year-end.

Trade and other payables

As a result of the audit matters detailed below, I was unable to verify the completeness, existence, obligations and valuation relating to trade and other payables amounting to R69 132 759, as disclosed in the statement of financial position for the current financial year and R59 717 605 for the previous financial year and the related detailed disclosure in note 12 to the financial statements.

- The entity did not accrue for invoices in respect of goods and services received amounting to R2 196 720 and an unknown amount in the prior year. I was unable to obtain sufficient appropriate audit evidence to satisfy myself as to the completeness of payables and the related expenses. The entity's records did not permit the application of alternative audit procedures.
- Included in note 12 to the financial statements an amount of R14 121 229 is reflected as payments received in advance. Sufficient appropriate audit evidence could not be provided to verify the nature and source of items included in this balance. Therefore it could not be determined whether payments received in advance were complete, existed, valued correctly and if the municipality had an obligation thereto. It could consequently not be confirmed whether all the items related to payments received in advance. The municipality did not investigate the nature and source of this balance and therefore we could not perform alternative procedures.

Trade and other receivables

As a result of the audit matters below, I was unable to obtain adequate audit evidence as to the existence, rights, valuation and completeness of trade and other receivables amounting to R54 209 472 (2009: R50 949 085) as disclosed in the statement of financial performance for the current and previous financial years.

- Additional information disclosed in note 3 in the prior year for ageing, customer classification and ageing of impaired receivables did not reconcile with the services receivable summary disclosed in the same note to the financial statements. I was unable to perform alternative audit procedures. Consequently, I was unable to obtain sufficient supporting documentation to confirm the existence, rights and valuation of trade and other receivables.

- Certain consumer debtors have entered into an agreement with the municipality to repay their accounts in periods exceeding 12 months. These debtors were not classified as long-term debtors, resulting in the understatement of long-term debtors and the overstatement of the trade and other receivables included in the statement of financial position. I was unable to determine accurately the misstatement due to the classification error.
- Included in note 3 to the financial statements are unallocated balances relating to prior years. It could not be confirmed that these amounts are recoverable as no movement has taken place on these accounts. Consequently, the existence and valuation amounting to R544 182 could not be confirmed.
- Departmental income is raised for monthly usage by the municipality's departments. Subsequently, the departmental debtor is derecognised at the end of each month to expenditure. At year-end a departmental debtor was included in the financial statements amounting to R4 802 543. Consequently, I concluded that departmental expenditure was understated by R1 921 491 and departmental revenue was overstated by R2 881 052.
- I was unable to obtain adequate audit evidence for amounts and balances included in the trade and other receivables amounting to R2 131 142. This was a result of supporting information that could not be obtained for the balances of suspense accounts on the debtors control account reconciliation and a reconciling item included in the reconciliation done between the debtors' age analysis and the general ledger closing balance. The amounts used to clear the suspense votes could not be followed through to the individual debtors' accounts, therefore no supporting documentation was obtained for the clearing of the suspense account. Consequently, the existence, valuation and completeness of trade and other receivables could not be confirmed.

Unspent conditional grants and receipts

The existence, valuation and allocation and completeness of unspent conditional grants and receipts as disclosed in note 13 to the annual financial statements amounting to R15 567 421 could not be concluded as the registers did not reconcile with the financial statements. An unexplained difference of R790 982 occurred between these registers and the financial statements.

The municipality's records did not permit the application of alternative audit procedures.

Financial statement disclosures

Contrary to the requirement of regulation 36(2) of the Supply Chain Management Regulations the reasons for any deviation in terms of sub-regulation 36(1)(a) and (b) were not included as a note to the annual financial statements.

Non-compliance with GRAP reporting framework

Contrary to SA Standard of GRAP, GRAP 1, *Presentation of Financial Statements*, the financial statements of the Metsimaholo Local Municipality did not provide information on whether resources were obtained and used in accordance with the legally adopted budget.

Irregular expenditure

Irregular expenditure amounting to R23 163 507 was not disclosed in the financial statements, as required by section 125(2)(d) of the MFMA. Payments amounting to R13 065 285 were made in contravention of the applicable legislation. For the remaining R10 098 222 supporting documentation could not be obtained. This irregular expenditure was identified during the audit and was not prevented or detected by the municipality's system of internal control.

I could not be provided with sufficient, appropriate audit evidence that management has properly identified, investigated and recorded all irregular expenditure transactions during the year under review. There were no satisfactory alternative audit procedures that I could perform to obtain reasonable assurance regarding the completeness of irregular expenditure.

Fruitless and wasteful expenditure

As disclosed in note 36 to the financial statements, fruitless and wasteful expenditure to the amount of R1 085 445 (2009: R876 653) was incurred. Subsequently, R86 066 was disclosed as fruitless and wasteful expenditure that was identified during the audit and was not prevented or detected by the municipality's system of internal control. An additional amount of R1 875 449 was identified during the audit that was not disclosed in the financial statements. An amount of R1 834 346 of the R1 875 449 identified related to input VAT that the municipality should have claimed on valid tax invoices. This was the result of management's decision to disregard the input VAT claim and not correct the VAT payable and related expenditure.

I could not be provided with sufficient, appropriate audit evidence that management has properly identified, investigated and recorded all fruitless and wasteful expenditure transactions during the year under review. There were no satisfactory alternative audit procedures that I could perform to obtain reasonable assurance regarding the completeness of fruitless and wasteful expenditure.

Cash flow statement

I was unable to obtain adequate audit evidence that the cash flow statement and related notes for the current and prior financial years were fairly stated, due to the material effect of scope limitations and identified misstatements mentioned in this report. The following differences were identified:

- Cash generated from operations was understated by R4 059 014
- Interest income was understated by R315 964
- Finance costs were understated by R204 678
- Purchase of property, plant and equipment were overstated by R679 238
- Sale of other receivables from non-exchange transactions was overstated by R2 876 376
- Total cash movement for the period was overstated by R1 973 461

Management representations

International Standards of auditing, ISA 580, *Management representations* states that the auditor shall disclaim an opinion on the financial statements in accordance with ISA 705 if management does not provide the written representations. Contrary to the requirements the written management representation could not be obtained from management.

Disclaimer of opinion

Because of the significance of the matters described in the Basis for disclaimer of opinion paragraphs, I have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, I do not express an opinion on these financial statements.

Emphasis of matter

I draw attention to the matter below. My opinion is not modified in respect of this matter:

Restatement of corresponding figures

As disclosed in note 37 to the financial statements, the corresponding figures for 30 June 2009 have been restated as a result of an error discovered during the financial year ended 30 June 2010 in the financial statements of the Metsimaholo Local Municipality at, and for the year ended, 30 June 2009.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

As required by the PAA and in terms of *General notice 1570 of 2009*, issued in *Government Gazette 32758 of 27 November 2009* I include below my findings on the report on predetermined objectives, compliance with the MFMA, and financial management (internal control).

Predetermined objectives

Material findings on the report on predetermined objectives, as set out on pages ... to, are reported below.

Non-compliance with regulatory and reporting requirements

Municipal Finance Management Act

Existence and functioning of a performance audit committee

The performance audit committee did not:

- meet at least twice during the financial year
- review the quarterly reports of the internal auditors on their audits of the performance measurements of the municipality
- review the Metsimaholo Local Municipality's performance management system and make recommendations in this regard to the council of the Metsimaholo Local Municipality
- submit an auditor's report to the Metsimaholo Local Municipality regarding the performance management system at least twice during the financial year.

Internal auditing of performance measurements

The internal auditors of the Metsimaholo Local Municipality did not audit the performance measurements on a continuous basis and did not submit quarterly reports on their audits to the municipal manager and the performance audit committee.

Usefulness of reported performance information

The following criteria were used to assess the usefulness of the planned and reported performance:

- **Consistency:** Has the municipality reported on its performance with regard to its objectives, indicators and targets in its approved strategic plan, annual performance plan and integrated development plan, i.e. are the objectives, indicators and targets consistent between planning and reporting documents?
- **Relevance:** Is there a clear and logical link between the objectives, outcomes, outputs, indicators and performance targets?
- **Measurability:** Are objectives made measurable by means of indicators and targets? Are indicators well defined and verifiable, and are targets specific, measurable, and time bound?

The following audit findings relate to the above criteria:

For the selected objectives, 63% of the planned and reported targets were not:

- specific in clearly identifying the nature and the required level of performance
- measurable in identifying the required performance
- time bound in specifying the time period or deadline for delivery.

Reliability of reported performance information

The following criteria were used to assess the reliability of the planned and reported performance:

- **Validity:** Has the actual reported performance occurred and does it pertain to the municipality i.e. can the reported performance information be traced back to the source data or documentation?
- **Accuracy:** Amounts, numbers and other data relating to reported actual performance has been recorded and reported appropriately.
- **Completeness:** All actual results and events that should have been recorded have been included in the reported performance information.

The following audit findings relate to the above criteria:

For the following reported target, number stands connected to new sewer network, that is material by nature, the validity, accuracy and completeness of the reported target could not be established as sufficient appropriate audit evidence and relevant source documentation could not be provided for audit purposes.

Compliance with laws and regulations

Municipal Finance Management Act

Expenditure was incurred in contravention of, or not in accordance with, applicable legislation resulting in irregular expenditure

Contrary to the requirements of section 1 of the MFMA, expenditure was not incurred in accordance with the requirements of the Supply Chain Management Regulations and the Remuneration of Public Office-Bearers Act as set out in the definition of "irregular expenditure" of the MFMA.

Expenditure incurred was made in vain or could have been avoided resulting in fruitless and wasteful expenditure

Expenditure incurred was made in vain and could have been avoided based on the fact that reasonable care had been exercised. This constitutes fruitless and wasteful expenditure, as defined in section 1 of the MFMA.

The annual budget was not prepared, tabled and approved in accordance with the applicable laws and regulations

Contrary to the requirements of section 16(2) of the MFMA, the annual budget was not tabled within the required time frames.

Supply chain management legislative requirements were not implemented or not adhered to

Contrary to the requirements of section 116(2)(b) of the MFMA, the performance of contractors was not monitored on a monthly basis.

Expenditure was not paid within the parameters set by the applicable legislation

Contrary to the requirements of section 65(2)(e) of the MFMA, expenditure was not paid within the required 30 days from the receipt of an invoice, or such a period as prescribed for certain categories of expenditure.

The internal audit unit was not properly established or not functioning properly

Contrary to the requirements of section 165(2)(e) of the MFMA, the internal audit unit of the municipality did not advise the accounting officer and report to the audit committee on the implementation of the internal audit plan and matters relating to compliance with the supply chain management regulations.

The financial statements were not prepared in accordance with applicable legislation

Contrary to the requirements of section 62(1)(c)(i) of the MFMA, the municipality did not have or did not maintain effective, efficient and transparent systems of internal control as required by legislation for guarding against fraud, theft and financial mismanagement.

The financial statements were not prepared in accordance with applicable legislation

Contrary to the requirements of section 122(1) of the MFMA, the municipality did not comply with all the requirements of the MFMA and consequently did not prepare financial statements in accordance with the legislative requirements. The financial statements submitted for audit purposes were subject to material corrections during the audit process.

Municipal Systems Act

Supply chain management legislative requirements were not implemented or not adhered to

Contrary to the requirements of section 7 of schedule 1 and section 5A of schedule 2 of the MSA, annual declarations of interest were not made by all the councillors and senior managers. I am not aware of any business transactions that occurred between these parties and the municipality.

INTERNAL CONTROL

I considered internal control relevant to my audit of the financial statements and the report on predetermined objectives and compliance with the MFMA, but not for the purposes of expressing an opinion on the effectiveness of internal control.

The matters reported below are limited to the significant deficiencies regarding the basis for disclaimer of opinion paragraph, the findings on the report on predetermined objectives and the findings on compliance with laws and regulations.

- **Leadership**

The accounting officer does not exercise oversight responsibility over reporting and compliance with laws and regulations and internal control which resulted in non-compliance to the applicable laws and regulations and irregular expenditure.

An effective organisational structure that places people with appropriate skills is not established. There is not an official tasked with the responsibility to maintain a GRAP compliant fixed asset register which resulted in a qualification on property, plant and equipment.

Among finance staff there was a general lack of understanding of the new accounting framework. This is evident due to errors that were identified during the audit process on provisions, payables, receivables, unspent conditional grants and receipts, non-compliance with GRAP reporting framework as well as the cash flow statement that were not prevented or detected and corrected and resulted in the modification of my report. Management should prioritise training of all staff including management on GRAP to facilitate efficient implementation and monitoring of compliance with GRAP standards and for the reliability of the annual financial statements.

- **Financial and performance management**

Requested information was not available and supplied without any significant delay. Due to supporting documentation not being available, qualifications on revenue, receivables unspent conditional grants and irregular expenditure occurred.

Systems are not appropriate to facilitate the preparation of the financial statements. This resulted in a qualification on receivables and revenue.

The financial statements and other information to be included in the annual report are not reviewed for completeness and accuracy prior to submission for audit purposes. Consequently, non-current provisions, financial statement disclosures and budget-related disclosures as per GRAP 1 were omitted from the annual financial statements. The cash flow statement was also materially misstated due to non-revision before submission of the financial statements.

Manual or automated controls are not designed to ensure that the transactions have occurred, are authorised, and are completely and accurately processed. Fruitless and wasteful expenditure was also not detected by the municipality due to misclassifications limiting the controls of the municipality to identify such expenditure.

Pertinent information is not identified and captured in a form and time frame to support financial reporting, therefore trade and other payables were qualified in respect of completeness.

- **Governance**

- Internal Audit Unit**

- The internal audit unit was not adequately capacitated, filling of vacant positions in this unit is still not been prioritized. The vacant senior management positions resulted in the division not having a strategic leadership that is necessary to provide adequate direction.

- Internal Audit Committee**

- Although the municipality had an operational audit committee during the period under review, the committee did not adequately review the financial statements prior to submission for audit purposes.

Auditor-General
Bloemfontein

30 November 2010



AUDITOR - GENERAL
SOUTH AFRICA

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